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UNCLAS SECTION 01 OF 04 SANTO DOMINGO 000194

SIPDIS

SENSITIVE

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TAGS: EFIN DR
SUBJECT: DOMINICAN PROGRAM WITH IMF: HIGH HURDLES,
UNCERTAIN PROSPECTS, WHILE COGENTRIX POSES A BIG OBSTACLE

¶1. (SBU) SUMMARY. On January 7 Econoff and USAID Economist called on IMF ResRep Ousmene Mandeng (PLEASE PROTECT) to review current status of IMF proposed program. The GODR has completed legislative action on budget items included as conditionalities and is close to complying with requirements for adjusting finances in the electricity sector. By retaining the August target for monetary growth, the IMF is, for now, asking for a virtually unachievable reduction of the money supply by 14 percent. The Central Bank Governor has explicitly restated the GODR policy of maintaining a free exchange market. The program makes Paris Club refinancing a condition for the announcement of the agreement. Various other conditionalities must be met before the program goes to the IMF board. In sum, the program poses high hurdles and offers a holding action which may get the country through presidential elections with a dollop of IMF money and extensive lending from the IDB and World Bank. This strategy could be jeopardized if creditors call sovereign guarantees on COGENTRIX loans, blocking IDB lending. END SUMMARY.

¶2. (SBU) On January 7 Econoff and USAID Economist called on IMF ResRep Ousmene Mandeng (PLEASE PROTECT) to review current status of IMF proposed program. The Fund and the GODR are finalizing the draft Letter of Intent (LOI), the Memorandum of Economic Policy (MOEP), and the Technical Memorandum of Understanding (TMOU). There are two sets of prior actions that must be implemented before any agreement is approved by the Fund Board.

¶3. (SBU) The first set of prior actions consists of pre-conditions to the formal announcement of the LOI and the sending of the proposed program documents to the IMF Board for approval. There are five components in the first set of prior actions:

a. A budget approved by the Dominican Congress. This action has been completed. The final budget negotiations resulted in changes of DR pesos 530 million from the original budget. The changes, which were acceptable to the Fund increased funding for the Congress and NGOs. This increase was funded by cuts in pensions and transfer to Municipalities, plus a broadening of the range of household goods subject to excise taxes. The increased taxes would generate DR$170 million, while the balance of DR pesos 360 million 0 would come from the expenditure reductions mentioned above.

b. An Electricity Sector Plan to &keep the lights on8 for the next six months. This plan, which must be approved by the World Bank, has three components:

i) tariff increases which must be formally published;
ii) development of a Statement of Electricity Development Policy (to be sent to the World Bank); and
iii) a detailed cash flow analysis for the next six months that shows the electricity sector companies are breaking-even by July 2004.

(Two of three requirements have been completed. The electricity tariff increases have been agreed to and announced. The new pricing scheme maintains the current subsidized rate for those consuming 200 KWH per month, for those consuming 200-700 KWH/month the subsidy is maintained for the first 200 KWH and the rates are increased 4 pct/month for consumption between 200-700 KWH/month, while for those whose monthly consumption is more than 700 KWH the subsidy on the first 200 will be phased out and the current rate increased by 7-8 pct/month until June 2004. Concerning the second component, the Statement of Electricity Policy Development, this has been done and submitted to the World Bank in December 2003. The cash flow analysis has not been submitted to the IMF as of yet.)

c. Reduction in the monetary base. The money supply is growing too rapidly and the IMF wants the monetary base to be reduced from DR pesos 77 billion to the original August target of DR pesos 66 billion (14 percent). This would be an enormous challenge, and ResRep indicated that the IMF would

evaluate this perfomance measure on the GODR's good faith efforts rather than on achievement of the actual target. The monetary base has grown in part because the holders of government certificates were not renewing them as they matured. There are several reasons for this reluctance to purchase Central Bank issued certificates. One concern is the fact that they offer a negative rate of interest. The inflation rate at the end of the year was 42 pct while the certificates were yielding 32-34 pct. A second concern of certificate holders is whether the Central Bank can finance the current stock of debt. Many think that the Central Bank will be forced to extend the length of maturity of certificates held by investors from 7-91 days to several years (at present the great majority of the certificates have a maturity of 30 days or less). Given these problems, it would appear that it will be difficult for the GODR to meet this target in the next several weeks.

d. A freely operating exchange rate market. In December the President announced the formation of a Commission to monitor the operations of the exchange houses. At the same time the President announced predetermined daily exchange rate reduction targets to reduce the exchange rate from around DR pesos 44 to DR pesos 30 for one U.S. dollar. The consequent actions resulted in a temporary reduction of the exchange rate to around DR pesos 34 to one U.S. dollar for several weeks. As a result of the government's actions, a foreign exchange black market appeared with the black market rate at around DR pesos 42 to one U.S. dollar.

(On December 30 Central Bank Governor Jose Lois Malkun reportedly met principal actors in the exchange rate business and told them the GODR would no longer seek to control the exchange rate. The dollar began to appreciate. On January 7 Lois Malkun told journalists, &The policy of the Central Bank is not to interfere in the exchange rate, which should be set by market forces. If the dollar rises, let it rise as it may.8 The Central Bank posted a public notice in daily newspaper Listin Diario on January 8 stressing the GODR agreement with the IMF to maintain a free exchange rate and advising that projected rates used by analysts in drawing up a program were estimates, not mandatory target rates. The peso has depreciated from its December strong point of DR pesos 34 per dollar to approximately DR pesos 42 as of January 9. The black market is said to exist still for those in urgent need of large amounts of dollars at short notice and may take several weeks to disappear completely.)

As a measure of performance for this issue the IMF is requesting that the Government publicly announce the elimination of the Commission monitoring the exchange houses. In addition the IMF has requested that the Commission on Financial Security be eliminated. This latter Commission has broad powers that could be used to impact the foreign exchange market. (On January 8 the GODR published extensive regulations dated December 18 for the oversight of exchange operations.) The ResRep left the impression that since bankers favor keeping this latter Commission to protect against credit card fraud and to halt rumors about the viability of banks within the country, the IMF might remove its objections to this Commission if it broad powers were curbed and clarified so as to eliminate the possibility it could be used to manipulate the exchange rate.

e. Financing assurances from the Paris Club. Paris Club refinancing is an essential element in the present proposed program. Without Paris Club refinancing the program is not viable. On January 14, the Paris Club will meet to consider the request for refinancing. The Paris Club must approve the request for refinancing and will consider the request to move the current cut-off date for refinancing from 1984 to the present or as close to the present as possible, so as to maximize the impact of the refinancing.

¶4. (SBU) Once the above pre-conditions are satisfied, the IMF will be in a position to make an official announcement of the agreement and forward the program to the Board. Even so, the formal Board Review will be dependent on the GODR meeting a second set of conditions. These are:

f. The Systemic Risk Law must be passed and signed into law. This law would among other things address weaknesses in the legal framework for addressing banking crises. (As of January 9 the Senate has passed this draft and it has gone to the Finance Committee of the House of Representatives.)

Embassy does not have any information at this time on the progress toward further remaining conditions:

g. The Monetary Board must approve regulations for the establishment of a contingency fund. The contingency fund would be similar to the Federal Deposit Insurance Corporation in the U.S.

h. Establishment of a Lombard-style refinancing facility. This facility would allow commercial banks facing a liquidity

problem to borrow from the Central Bank. It is meant to be a last-resort lending facility. To discourage banks from using it except in emergency situations, the interest rate charged by the Central Bank would be substantially above market rates.

i. Finalization of the Terms of Reference for establishment of a panel to evaluate the assets of the two electricity distribution companies that the GODR purchased from the Spanish company Union Fenosa. This is a follow-up to the recommendations of the International Board that reviewed the purchase of the distribution companies. The intent is to assess whether the price paid was appropriate to the value of the companies.

j. Establishment of a Panel to review the weaknesses of the financial system and recommend actions to resolve them. The Panel will be charged with reviewing the recent financial sector problems to determine their cause, to identify weaknesses that need to be addressed and develop recommendations to address them.

k. Clearance of the more than USD 100 million of arrears that will not be subject to rescheduling. The GODR has recently met urgent financing needs by accumulating arrears. The USD 100 million consists of arrears not subject to rescheduling under Paris Club. Given the GODR,s financial plight, clearance of the arrears would seem to be possible only if the IDB releases the first tranche of its emergency loan before the program goes to the Board.

¶5. (SBU) Once these actions have been completed, the IMF Board will meet for approval of the resumption of the program. It would appear that the earliest the Fund Board could act would be in early February. Once the program is approved, the Fund will release a second tranche of USD 60 million, the only release of Funds until after the May 2004 elections. (If a second round of presidential voting is required, it will take place on June 30.) The Fund has dropped the monthly reviews of the program with the GODR and will not conduct a review until June or July, after the elections, and will determine at that time whether conditions warrant the release of the third tranche.

COMMENTS ON IMF PROGRAM

¶6. (SBU) Emboffs consider this to be a deliberately short-term emergency program designed to give the Mejia administration the barest chance to make it though the presidential elections. Conditionality is strict and challenging. The Fund itself is committing very little in resources. Almost all the likely funding of USD 300-400 million will have to come from the IDB and the World Bank, and of that amount about USD 100 million must go towards arrears before the program goes to the Board.

¶7. (SBU) Given the upcoming May election, the GODR could well have difficulties sticking to such a tight program, even in the best of circumstances. Although the ResRep did not say so, the schedule suggests that the IMF will wait until after the May 2004 presidential elections to revise or completely to renegotiate the program. The Fund is conserving its resources and passing the financing burden to other IFIs over the next six months to support the holding action. The calendar is not kind, either -- the next GODR will not take office until August 16, and President Mejia is not currently favored to win his bid for re-election. And when the time comes to elaborate a new program, the multilateral development banks will almost certainly have to stump up just as much, and even more than before.

COGENTRIX THREATENS TO PULL THE HOUSE DOWN

¶3. (SBU) Further complicating the GODR's precarious finances is a face-off over arrears due to electricity generating firm COGENTRIX. The GODR has been in arrears to the firm since September and technically in default since November. President Mejia continues to refuse to pay COGENTRIX unless the management explicitly agrees to negotiate lower rates for electricity generation; Mejia says that the firm acted in bad faith in mid-2003 when it reneged on an understanding that it would negotiate if the GODR cleared arrears. The amount due grows monthly by about USD 3.7 million, due to a "take or pay" clause in the contract. According to the terms of the loans, creditors have the right to call at any time sovereign guarantees amounting to approximately USD 400 million (including penalties) for IDB and private sector loans.

¶4. (SBU) Embassy understands that COGENTRIX creditors have given the GODR until January 14 to pay all arrears, amounting to about USD 35 million. Ironically, COGENTRIX is obliged by the contract to renew a performance bond of USD 10 million. COGENTRIX has requested that the GODR waive this requirement, in return for which the creditors offer to extend their deadline for payment of arrears a further two weeks, until January 29. A call of the guarantees would have catastrophic

effects on GODR finances -- it would immediately cut off IDB lending (essential to the program defined with the IMF) and would lead to a sharp further downgrade of the ratings for GODR bonds. This is a commercial dispute between a sovereign government and various creditors, including a number of U.S. nationals, but it also has important policy implications for the USG. The USG role should continue to advise the GODR to come to terms, should closely monitor the developing situation, and should encourage the IDB to mediate between the two parties.
MARSHALL